

## Centralized Clearing of OTC Derivatives: Devil in the Details

January 2010

A new Greenwich Market Pulse shows that corporations and financial institutions around the world broadly agree that moving OTC derivatives trading to a system of centralized clearing would be an effective means of managing both counterparty risk at an individual level and market-wide systemic risk.

However, financials and corporates also have some serious concerns about the ongoing process of market structure reform. Some of these concerns stem from the fact that market participants are uncertain about details of the proposals being considered. Other concerns involve more informed questions among users of OTC derivatives about how the switch to centralized clearing would impact overall market liquidity and costs, as well as corporates' ability to effectively hedge risk positions.

Two clear conclusions emerge from the study results:

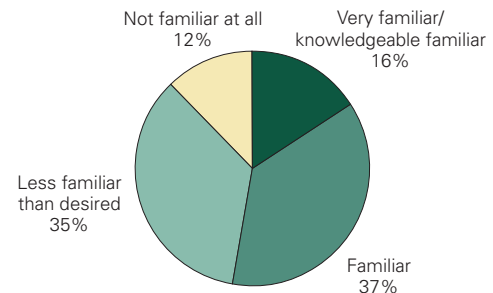
- The marketplace requires more information directly from regulators about the timing, scope and specific provisions of centralized clearing initiatives in various markets and jurisdictions.
- In taking steps to mitigate systemic and counterparty risk in OTC derivatives markets, regulators must be sure to address serious concerns about not only the primary impact of reforms on market liquidity and functionality, but also secondary consequences such as the impact on or new limitations on current corporate hedging practices.

### Users Cite Information Shortages

Although 53% of the 330 investors and corporate executives surveyed globally by Greenwich Associates from January 11–15, 2010 describe themselves as familiar or very familiar with current proposals to establish centralized clearing for OTC derivatives, a surprisingly high 47% of respondents say they are either entirely in the dark about these initiatives or less knowledgeable than they would like to be about the details of the proposals.

As might be expected, the most active users of the OTC derivatives products at the center of the proposal changes appear to be the best informed. At least two-thirds of corporates and financial institutions that use commodity options, commodity swaps, and credit default swaps and index products say they are familiar or very familiar with current centralized clearing proposals.

### Understanding Current Centralized Clearing Proposals for OTC Transactions



Note: Based on responses from 330 investors and corporate executives. Percentages may not equal 100 due to rounding. NA/Uncertain responses have been excluded. Source: 2010 Greenwich Market Pulse - CCTT

For corporates and financials less familiar with the proposals, the problem appears to lie not in a lack of information, but rather in a barrage of often conflicting information on what specific proposals should and do include and what impact the provisions will ultimately have. The situation can be particularly confusing for corporates and financials that are only infrequent users of OTC derivatives. "People who are less engaged with the twists and turns of the regulatory reform process have a hard time sifting through the different messages they hear from regulatory bodies in various jurisdictions, exchanges, big banks and other constituencies, each of which approach the issue with their own perspectives and interests," says Greenwich Associates consultant Andrew Awad.

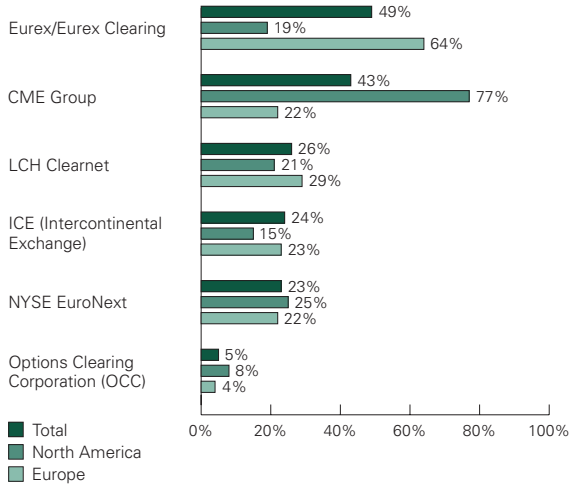
Many of the survey participants say they would welcome clarification on several critical, basic issues, including which asset classes would be affected under the various proposals, whether centralized clearing would apply to all customer trades or only to inter-dealer trades and when each proposal would take effect if approved. Respondents also say they would like additional information on the following points:

- Jurisdictions covered
- Timing of implementation in both Europe and North America
- Impact on FX markets and products
- Details on how margin requirements will be calculated
- Potential limitations on transaction sizes

## Where Should Central Clearinghouses Reside?

Which organizations should run central clearinghouses for OTC derivatives? Corporates and financial institutions in continental Europe favor Eurex as the home for the region's clearinghouse. U.K. companies and financials prefer LCH Clearnet, with Eurex and Intercontinental Exchange (ICE) also receiving votes. The preferred provider of North American corporates and financial institutions is CME Group.

### Preference for Central-Counterparty for Clearing OTC Derivatives



Note: Based on responses from 136 investors and corporate executives. NA/Uncertain responses have been excluded. Source: 2010 Greenwich Market Pulse - CCTT

- Possible exemptions
- Grandfathering of existing trades

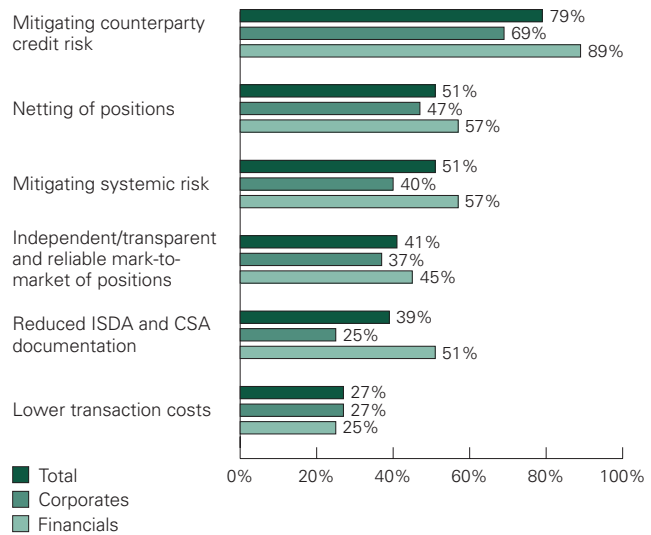
“With so many corporates and financial institutions lacking clarity on such fundamental issues, it is hard to imagine how they could accurately assess whether a move to centralized clearing would be a net positive for their businesses or for the system as a whole,” says Greenwich Associates consultant Frank Feenstra.

### Mitigating Counterparty and Systemic Risks

Corporates and financial institutions around the world largely agree that the move to centralized clearing would be an effective means of mitigating issues of counterparty risk in OTC derivatives trading. Approximately 80% of survey participants overall cite counterparty risk mitigation as the primary benefit of centralized clearing, a share that approaches 90% among financials. At a broader level, almost 51% of survey participants believe a move to centralized clearing would be effective at mitigating systemic risk.

“Financials and corporates agree that the need for centralized clearing is most pressing for credit default swaps, which emerged as a key source of both counterparty and

## Most Important Benefits for Centralized Clearing of Derivatives



Note: Based on responses from 229 investors and corporate executives. NA/Uncertain responses have been excluded. Source: 2010 Greenwich Market Pulse - CCTT

systemic risk during the global financial crisis,” says Greenwich Associates consultant Woody Canaday.

Even on the issue of risk mitigation, however, some remain skeptical. A survey participant from a global integrated energy company based in Europe explains his concerns about the proposed reforms. The company hedges its currency and interest rate risks using OTC financial derivatives, which he says are “carefully managed through a set of guidelines and carefully supervised both at an operational, and at a managerial level.” He also says that his company is strongly committed to supporting efforts to address counterparty risk. “Having said that,” he continues, “we are seriously concerned by the proposed reform that would set up a centralized clearinghouse for interest rates and foreign exchange derivatives, because we fear that such change would not reduce concerns at a global level, since it would just shift risk from counterparty to liquidity.”

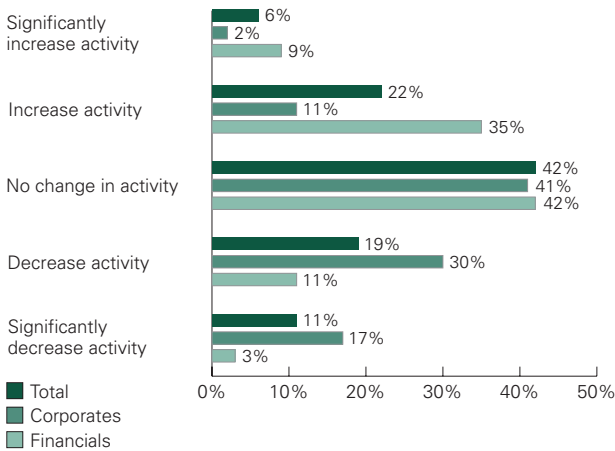
### Impact on Trading Volumes

As regulators, banks and customers contemplate the establishment of centralized clearing systems as a means of reducing risk, one of the critical questions they are attempting to answer is what impact that the shift would have on volumes of OTC derivatives trades. Supporters contend that, in addition to addressing critical risk issues, a move to centralized clearing could ultimately result in an increase in trading volumes.

The question of whether a move to centralized clearing would increase or decrease trading volumes is important because it gets to the heart of the deeper question of how a reform designed to address issues of counterparty and

systemic risk would impact market liquidity and functionality. In that light, regulators considering various proposals should take into account the fact that users of OTC derivatives have differing views on how current proposals would affect trading volumes. Overall, 42% of survey respondents do not think a shift to centralized clearing will have any effect on the notional trading volumes they execute in OTC derivatives. Among financial institutions, 44% of respondents agree with supporters and predict that their notional trading volumes will increase under a system of centralized clearing.

### Impact of Centralized Clearing on Notional Trading Volume of Derivatives



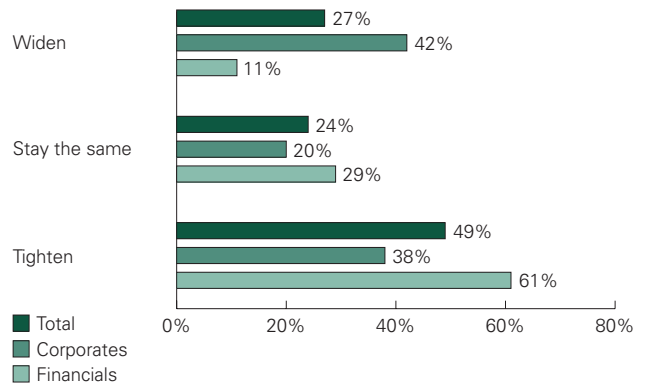
Note: Based on responses from 229 investors and corporate executives. Percentages may not equal 100 due to rounding. NA/Uncertain responses have been excluded. Source: 2010 Greenwich Market Pulse - CCTT

“However, nearly half of the corporations interviewed indicate that they expect the notional volume of derivatives trades they execute to decrease if a centralized clearing is mandated,” says Greenwich Associates consultant Peter D’Amario. “This prediction is based on two main factors: potential increases in costs and possible decreases in customers’ ability to customize contracts.”

### Impact on Costs

While half the survey respondents predict that a move to centralized clearing will lead to tighter bid/ask spreads on OTC derivatives, 47% of corporates believe the move will result in wider spreads at least in the near term. Although the expectations of this latter group seem to contradict the general consensus that increases in standardization and transparency tend to drive spreads tighter in OTC markets, many corporates express what seems to be a logical point of concern: there will be costs associated with creating and maintaining the centralized clearing system and those costs will ultimately be passed on to customers. That being the case, the ultimate impact on market pricing would depend on whether spread compression from transparency and standardization outweighs the new costs.

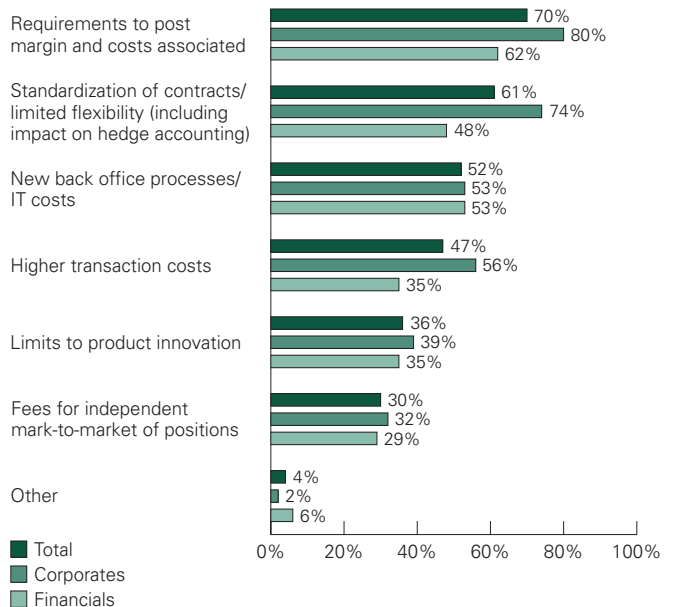
### Impact of Centralized Clearing on Bid/Ask Spreads for OTC Derivatives



Note: Based on responses from 234 investors and corporate executives. Percentages may not equal 100 due to rounding. NA/Uncertain responses have been excluded. Source: 2010 Greenwich Market Pulse - CCTT

A survey participant from a large European company explains why he believes his overall costs would rise under centralized clearing, regardless of any potential for tighter spreads. “Although there would be a credit advantage to centralized clearing, I believe the reduction in trading in the market in general as a result of this environment will make products less liquid and therefore more expensive,” he says. A survey respondent from a U.S. company explains his belief that centralized clearing will increase his costs by noting that “dealers will price to the lowest common denominator instead of giving good credit the benefit of good credit pricing.”

### Foreseen Concerns with Centralized Clearing of Derivatives



Note: Based on responses from 225 investors and corporate executives. NA/Uncertain responses have been excluded. Source: 2010 Greenwich Market Pulse - CCTT

Overall, 47% of survey respondents cite the potential for increased transaction costs on OTC derivatives trades as a significant drawback of centralized clearing and 70% see the potential for increased costs associated with margin requirements as an important negative consequence. Corporations on their own are much more pessimistic about centralized clearings' impact on costs, with 56% expressing concerns about increased transaction costs and 80% noting higher costs from margin requirements as a drawback.

Among the 44% of financial institutions predicting that their notional trading volumes will increase under a system of centralized clearing, rationales for this belief echo the arguments made by centralized clearing proponents: By creating transparency and imposing standardization, the move to centralized clearing will squeeze spreads, lower overall trading costs and thereby stimulate trading activity. Notably, customization of contracts is less important for financials than corporations. Approximately 60% of financials think centralized clearing will result in tighter spreads.

### Impact on Customization

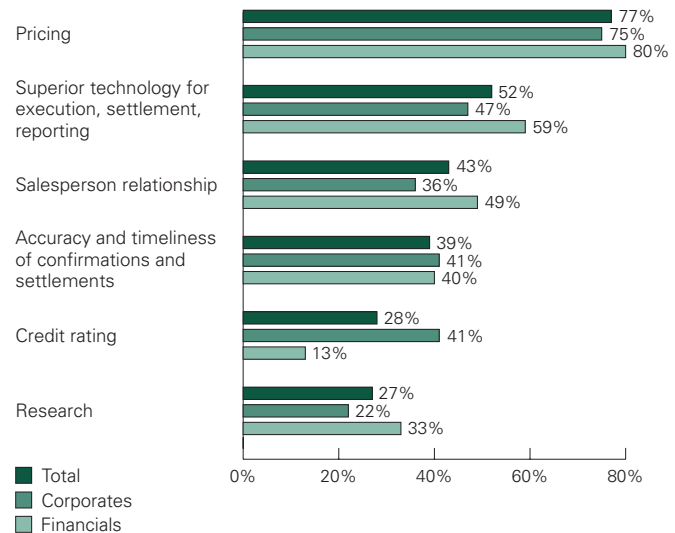
Approximately three-quarters of corporations fear the newly enforced standardization of contracts required by a shift to centralized clearing will limit flexibility, creating mismatches in positions and disqualifying some trades from hedge accounting. After concerns about cost increases from margin requirements, this lack of customization ranks as the most important drawback of centralized clearing in the minds of corporations. "The question of how changes in the market structure will affect companies' ability to hedge risk exposures and positions is certainly a question that should be front-and-center in discussions about a move to centralized clearing," says Greenwich Associates consultant Tim Sangston.

### Differentiating Dealers

Amid the many things that corporates and financial institutions expect to change with a shift to centralized clearing, survey participants predict one thing will stay the same — price will remain the driving force in decisions about which dealers to use for OTC derivatives trades. However, if — as expected by many — the increased transparency and standardization imposed by centralized clearing drives spreads tighter, pricing differentials from dealer to dealer will likely erode over time. As they do so, other, secondary characteristics will begin to play a bigger

role in the dealer selection process. In a system with centralized clearing, corporations and financials predict that three factors will increase in importance as criteria for choosing a dealer: the quality of dealer technology for execution, settlement and reporting, relationships with sell-side salespeople and the accuracy, and timeliness of confirmation and settlements.

### Differentiating Factors for Dealers in Centrally Cleared Environment



Note: Based on responses from 248 investors and corporate executives. NA/Uncertain responses have been excluded.  
Source: 2010 Greenwich Market Pulse - CCTT

*Greenwich Associates consultants Andrew Awad, Woody Canada, Peter D'Amario, Frank Feenstra, and Tim Sangston advise on fixed-income markets globally.*

### Methodology

Greenwich Associates surveyed 330 financial institutions and corporate users of derivatives in North America, Europe and Asia on their views of proposed centralized clearing of OTC derivatives. Surveys were conducted via the internet from January 11 through January 15, 2010.

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